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International Monetary System: The Desired Direction of Changes

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Abstract

The collapse of the international monetary system of Bretton Woods ended the period of common use of unified exchange rate system. Current, so-called non-system, is not providing stability in currency relations, which is mainly due to the high volatility of exchange rates. Implementing changes is inevitable. While the unification of exchange rates on an international scale appears to be currently impossible, alike the return to the gold standard, noteworthy is the idea of implementing a global currency, which would be an effective replacement for the US dollar as an international currency. SDRs, based on the rearranged currency basket that include the currencies of developing countries, could successfully play the role of such currency.

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1. Introduction

For a number of years the world has been witnessing the process of financial integration increasing the scale and the frequency of capital flow between countries. Pursuing the exchange rate policy under these circumstances becomes a significant yet challenging task.

The collapse of the international monetary system of Bretton Woods ended the period of common use of unified exchange rate system. Current, so called "non-system" provides countries with the freedom to choose their preferred

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exchange rate regime. However, this solution has a significant drawback. It results in the lack of stability in the foreign exchange relations, which is mainly due to the high volatility in exchange rates.

Implementing changes is inevitable. While the unification of exchange rates on an international scale appears to be currently impossible, alike the return to the gold standard, noteworthy is the idea of implementing a global currency, which would be an effective replacement for the US dollar as an international currency.

2. International monetary systems - historical overview

The international monetary system is a set of general rules, legal norms, instruments and institutions shaping payment conditions in foreign trade (international scale). It is formed as a result of multilateral international agreements (often with the participation of international financial organizations) or as a results of practical experience of global trading participants. There is a set of rules defined within the international monetary system, concerning: fixing exchange rates, equalizing the balance of payments or establishing an international currency (if its decided to be issued) (Dorrucci and McKay, 2011).

The Gold Standard is considered to be the first international monetary system. It was officially introduced in England in 1816, although the system was adopted there almost a hundred years before that date. The gold standard system was used widely throughout the world in the XIX and early XX centuries (in the majority of countries until the outbreak of World War I) Its operation was not based on any international agreements. The rules of the system were individually sanctioned with legal acts provided by the state authorities of particular countries (Economic History Service, 2015).

The characteristic feature of the gold standard was the unlimited convertibility of currency into gold according to strict rules. Each economic unit of account could be converted into a fixed quantity of gold (so called Gold Standard), for instance 1 USD = 1.505 g of gold. In addition, the state guaranteed the convertibility of currency into gold. Each state authority was responsible for fixing the gold standard. During the period of the Gold Standard, there was a freedom of minting coins as well as converting them back into bullions (White, 2008).

The gold standard was characterised by high stability, which facilitated trade among countries. The system eliminated exchange rate fluctuations. The mutual rate between currencies was strictly related to the gold standard ratio between them (for instance, if an ounce of gold was worth 4.25 GBP and 20.67 USD, the exchange rate of USD to GBP was 20.67/4.25 or 4.86 USD for 1 GBP). Fixed exchange rates contributed to the development of international trade due to the elimination of exchange rate risk (Begg and Fischer and Dornbusch, 2003).

The system was advantageous due to its automatic influence on maintaining the stability in the balance of payments of the state. The deficit in the balance of payments caused the outflow of gold reserves, which in turn yielded a decrease in the money supply in the domestic market and further a decline in domestic prices. Lower prices enhanced export development (export prices for goods became lower and therefore more attractive to foreign buyers) and decreased import (due to the high prices of imported goods). Simultaneously, exports increased and import declined, both contributed to maintaining the stability in the balance of payments. Its pace depended on the rate at which domestic prices reacted to the pressure created by the deficit in balance of payments. The automatism of restoring the balance of payments could, however, be derailed by various state actions taken on the financial market. This includes raising the interest rates in order to stimulate the inflow of capital (in terms of capital turnover). Such an operation allowed to keeping gold resources on a fixed level (remained unchanged), which reversed the downward pressure on prices in the country and thus influenced the demand of export and import. Due to that, the trade deficit lasted slightly longer.

In addition, the Gold Standard disallowed the maintenance of a high inflation rate in the countries that had this system introduced. The issue of money in the country was dependent on its gold reserves. Price fluctuations could mainly be caused by the outflow of large quantities of gold or by the discovery of new gold lodes.

The Gold Standard, however, also had a significant weakness. It precluded the creation of money on a large scale, which significantly limited the cash flow and inhibited the development of economies. A number of which, fell into a long-term recession.

Economists' opinions on the effectiveness of the gold standard are divided. Some of them consider the system perfect emphasizing its stability, whereas others, perceive it as an obstacle to the economic development of the world.

The outbreak of World War I and the need to finance military activities led to the abandonment of the gold standard. Enormous military spendings caused the issue of banknotes in an amount far beyond the means of covering them by the gold reserves. Most countries have therefore suspended the convertibility of their currencies into gold. Also, the freedom of gold import and export was abolished. The monetary system moved away from gold and the gold standard currency was replaced by paper money. Gold coins disappeared from circulation and moved to the vaults of issuing banks. Some part, however, has been thesaurized by the citizens. Banknotes of which the convertibility into gold had been suspended, became irredeemable paper money. Simultaneously, many countries introduced treasury notes directly issued by the government (so called, assignation) The issue of paper money was directly controled by the government without considering the current gold reserves. Trade between countries was based on the exchange rate which was different from the statutory monetary parity. This rate had been shaped by the extent of supply and demand in the foreign exchange market. The state could, however, impose restrictions on its citizens in making foreign exchange transactions, or allow relative freedom of such operations.

After the end of World War I there was an attempt to return to the Gold Standard, perceiving it as a system that guarantees the stability of international trade. The attempt was successful in the United States where the pre-war system was re-implemented allowing gold coins to circulate again and the banknotes could be converted into gold. Some of the countries preserved their paper currency system until a few years after World War I (considering it as a temporary sollution and aiming on the reimplementation of the Gold Standard).

There was a conference held in 1922 in Genoa at which a set of principles concerning the new international monetary system were formulated. However, it was not the gold standard but only its modification. The new system was named the "Gold Bullion Standard". Banknotes were exchanged for gold bullion of a fixed weight (not in coins) This meant, that the exchange was available only where the large sums of money were involved. This system, in contrast to the gold standard, did not guarantee the free convertibility of currencies into gold.

The Gold Bullion system collapsed in 1931. The collapse of the system was dictated by the economic crisis of 1929-1933, which affected almost the entire globe. The first symptome was a significant drop in share prices on the New York Stock Exchange on Wall Street. The events from 24th of October 1929 are referred to as "Black Thursday". The drop in stock prices led to a wave of bankruptcies, which quickly resulted in massive unemployment (which in the United States amounted to 1/3 of the workforce) and a decrease in production. The volume of world trade decreased significantly. Due to high unemployment, countries were unable to comply with the rules of the Gold Bullion system, which valued the external balance over the internal.

The problems arising from the great economic crisis required making fundamental changes in the monetary system. Three main directions of changes emerged and were implemented by three different countries: Great Britain, Germany and the USA.

Great Britain left the gold standard. The pound became paper currency, non-exchangeable for gold (but remained freely convertible into other currencies). Its exchange rate was shaped by the extent of supply and demand for pounds. This rapidly led to the devaluation of the pound in relation to foreign currencies, which incurred financial loss on the countries still maintaining the gold standard system and those that had large debts in pounds. Due to the fact that pounds was the key currency of the capitalist world, its constant exchange rate fluctuations in relation to foreign currencies were unacceptable. Therefore, in mid 1923 the Exchange Equalisation Account was establish, whose role was to maintain the stability of the pound in relation to foreign currencies.

Germany formally maintained the Deutsche Mark parity unchanged. In practice, however, as of July 1931, the convertibility of the Deutsche Mark was suspended, imposing severe restrictions in making foreign transactions (introducing foreign exchange and commodity control) which allowed the stability of balance of payments to be kept. The restrictions of foreign exchange control included:

- any foreign exchange inflow must be sold to the bank authorized by the state,
- each international payment must be authorized by a competent authority
- foreign transactions must be performed with the use of the official exchange rate (for certain transactions, however, the rate could be diversified).

Foreign trade turnover was also subject to the regulations, however, each country was provided with compensation to bilateral clearing agreements.

The United States initially decreased the USD parity, but maintained its convertibility into gold for foreign payment purposes. The Great Depression of 1933 caused the suspension of convertibility of the dollar into gold (gold was completely withdrawn from circulation).

Changes in the monetary system in the interwar period clearly swayed into the direction of state interventions in the field of international relations. While the old system was aimed at maintaining the stability of the currency, increase in employment, production and income became the new main objectives of the monetary policy. The extent of lending activities became subordinate to the state government policy instead of gold reserves.

The period between the First and the Second World Wars is undoubtedly a period of chaos in the exchange relations. After World War II there was an attempt to rearrange the system.

In July 1944, the conference in Bretton Woods congregated representatives of 44 countries in order to develop a new international monetary system. The result of the meeting was the signing of the agreement currently known as Bretton Woods System. The system based on bonding the US dollar with gold. The value of USD was fixed at 1/35 ounce of gold. However, the dollar was not a commonly convertible currency. The exchange was allowed only for governments and central banks. Monetary exchange parities were set in gold or in dollars - i.e there was a fixed amount of gold or dollars per currency unit of a particular country. Currencies of countries involved in the system were not allowed to be converted into gold (with the exception of USD) but only into dollars. A huge spread in the monetary parities could be observed. Parity changes were infrequent and were performed under the scrutiny of the International Monetary Fund (IMF), which was bound to consider the economic interest of other member states. Parity was changed if a country expressed a persistent imbalance of payment i.e that the country was unable to remove the chronic deficit or surplus in its balance of payments (Bordo, 2015).

Currency exchange rates were stabilized and were allowed to fluctuate only within narrow limits. The Bretton Woods system bounded the member states to maintain the exchange rate of their currency within +/- 1% range. In order to comply with the system rules, the Bank for Reconstruction and Development (IBRD), and the International Monetary Fund (IMF) were established.

The extent of issue of money and lending activity was not dependent on gold reserves and foreign exchange but were shaped by the monetary authorities of the state, whose aim was to establish a high rate of economic growth, eliminate unemployment and stabilize the price level.

For the first several years the Bretton Woods system operated effectively. The problems emerged in 60s, when the United States observed significant payment issues. Moreover, maintaining a stable gold price was extremely complicated. Facing the constant price increase around the world, maintaining a fixed gold price resulted in reducing the interest of its production. The effect of which was the decrease of gold participation in the structure of global reserves.

In the late 60s early 70s of XX century, there was an attempt to implement changes within Bretton Woods system in order to ensure its continuous and efficient operation. In 1968 two level of gold prices were introduced - the official level (35$ per ounce) and the free market. In 1970 the IMF introduced the Special Drawings Rights (SDRs). SDR was a new mean of payment, its parity was equal to the parity of dollar, but the SDRs were not convertible into gold. The introduction of SDRs was tantamount with the gradual recede of dollar as a global currency. In 1971, dollar into gold conversion was officially suspended, conducted the devaluation of dollar and increased the fluctuation range of exchange rates from +/- 1% to +/- 2.5%. In 1973, second devaluation of dollar was conducted, raising the official price of gold to 42.20$ per ounce.

Unfortunately, implemented changes were insufficient due to the intensification of currency speculation and inflation, as well as due to the persistent deficit in balance of payments of the United States. At the beginning of 1973, the Bretton Woods system finally collapsed. Most countries introduced floating exchange rates. Which led to the formation of a multi-polar system based on a multitude of international currencies.

3. Current international monetary system

Current international monetary system is referred to as multi-polar system or non-system. The system, however, is not a result of international negotiations but an outcome of actions undertaken by individual countries in terms of exchange rate policy. A characteristic feature of this system is the multitude of currencies, which play the role of an international currency - alongside dollar and euro this includes the currencies of countries which hold the international financial centres (United Kingdom, Switzerland, Japan) Countries independently decide whether their exchange rates are fixed or variable. They also have the autonomy to establish the reference point for pegged exchange rates. Gold is no longer a global currency. The government-set price for gold was abolished. Gold is also no longer a determinant factor for establishing currency parities, as well as not used to regulate the payment obligations. However, gold is still hold in the vaults of Central Banks and international financial institutions. Global gold market is under a significant influence of developing countries, particularly India and China. These countries are the biggest gold recipients. The role of dollar in the international monetary system has decreased, yet it is still a currency of high importance in the field of international relations (Bush and Farrant, 2010).

Within current international monetary system we have a variety of regional and national currency systems.

A great example of regional monetary system is the European Monetary System (EMS) implemented in March 13, 1979 which operated until 1998. The European monetary unit called ECU was an important element of this system. Its value was determined on the basis of currency basket of European Economic Community (EEC). The ECU served as an international non-cash, currency. This unit of account was used in EEC financial transactions, as well as a legal tender in transactions between central banks of EEC member states. ECU was a part of foreign exchange reserves for European Monetary System members (www.civitas.org.uk, 2015).

Exchange Rate Mechanism was another crucial element constituting the basis of the system. This mechanism is based on the determination of two exchange rates i.e: the exchange rate of main EEC currencies in relation to ECU - and bilateral exchange rates between the EEC currencies. It was agreed that the exchange rate of individual currencies in relation to the central rate can fluctuate within the range of +/- 2.25% (fluctuation for a certain currencies was temporarily increased to +/- 6%). In 1993 the fluctuation band was increased to +/- 15%. The EEC member states agreed, that when the exchange rate of the national currency against the other deviates too much (beyond the permissible deviations range), two of the member states are bound to intervene in the market:

- state with a weak currency, which exchange rate dropped to the lowest permissible limit, will sell its partner strong currency in order to stimulate the demand for its domestic currency and improve its exchange rate.
- state with strong currency, which exchange rate analogously increased to the upper fluctuations limit, will buy the weak currency from the market for its own currency.

Undoubtedly, the burden of the intervention was more severe for state with weak currency, since its reserves were limited and when they were exhausted the state was forced to implement the deflation policy, unlike the state with strong currency was not forced to lower the interest rates in order to lower the rate, since its reserves were not endangered. Therefore, second intervention plan was adopted where only one state was bound intervene in the market. The basis of which was the fluctuation of national currency exchange rate in relation to the ECU. The range of this fluctuation was established as 1.69% drop or increase from the central exchange rate. The intervention point (fluctuation band) was, however, different for each state. The calculation of which included the participation of national currency in the ECU basket.

Financial Support Mechanism was the third component of the European Monetary System. Its essence was to enable the intervention of the European Monetary Fund in order to maintain the exchange rate within a reasonable fluctuation range. The intervention constituted of the assistance in a form of a loan provided by the European Monetary Fund.

European Monetary System operated until 1998. The year 1999 was the year of change. European Union (EU) member states decided to introduce EURO. This unit of account was introduced in 11 of the contemporaneous 15 EU member states (countries that have not adopted EURO were: Great Britain, Denmark, Sweden and Greece). Currently (2015) eurozone involve 19 member states (out of 28 that are members of the EU). State, which desire the will to join the eurozone must meet the conditions, formulated by the EU member states at the conference in Maastricht (1992). These conditions relate to the amount of the budget deficit, public debt, inflation, interest rate and exchange rate of the state applying to join the EMU.

4. International monetary system of the future

Non-system is definitely not a perfect solution. Its main drawback is the volatility of the exchange rate, which makes this system perceived a relatively unstable (Farhi and Gourinchas, 2011). Moreover, despite the present of multiple international currencies, dollar is still the most significant one (Eichengreen, 2015) USD is the primary reserve currency for most countries around the world. Therefore, any changes in its value cannot remain unnoticed by the rest of the world. The effect of global financial crisis, started in the mortgage market in the United States in 2007, clearly shows that the world economy dependence on a single currency yield a huge risk for the stability of the global financial market (Mohan and Patra and Kapur,2013). Therefore, it seems reasonable to introduce a "replacing currency" for USD as the international currency, which value would not be dependent to such extent from actions taken by one particular country (www.economist.com, 2010)

The idea of global currency is not new. Already in 1944, such solution was presented by British economist John Keynes. He proposed the introduction of an international reserve currency detached from any country. It was the so called Bancor, however, his idea has never been implemented (Lago and Duttagupta and Goyal, 2009).

International currency, however, was introduced in 1967 by the International Monetary Fund. It was described by the term - Special Drawing Rights (SDRs). This is a non-cash currency existing only in the form of accounting entries in bank accounts. The only entities entitled to use the SDRs are Central Banks and certain financial institutions. The SDR is primarily used to regulate country obligations under the current balance of payments and during the comparison of exchange rates in international settlements.

SDR units were issued three times. The first tranche of 9.4 billion was issued in 1970-1972. Second, of 12 billion in 1979-1981. The third was issued in 2009 with the value of 204.1 billion. SDR units are granted to IMF member countries proportionately to their contribution to IMF (www.imf.org, 2015).

Initially, the SDR value was exclusively shaped on the basis of gold value. It was established that, 1 SDR is the equivalent of 0.888671 g of pure gold. This was changed in 1974. The SDR value is currently based on the currency basket, which includes: EURO, yen, pound sterling and USD. The value of each currency included in the basket depends on its participation in the international financial transactions. Currently (i.e according to the currency basket of 2011-2015) the value of particular currencies present as follows: USD 41.9%, EUR 37.4%, JPY 9.4%, GBP 11.3%. The value is determined for the period of 4 years. Table 1. shows the composition of the currency basked during the period of 1981-2015.

Table 1. Participation of currencies in the SDR basket

Period	**Participation of currencies in the SDR basket**
1981-1985	USD 42%, DEM 19%, JPY 13%, GBP 13%, FRF 13%
1986-1990	USD 42%, DEM 19%, JPY 15%, GBP 12%, FRF 12%
1991-1995	USD 40%, DEM 21%, JPY 17%, GBP 11%, FRF 11%
1996-2000	USD 39%, DEM 21%, JPY 18%, GBP 11%, FRF 11%
2001-2005	USD 45%, EUR 29%, JPY 15%, GBP 11%
2006-2010	USD 44%, EUR 34%, JPY 11%, GBP 11%
2011-2015	USD 41,9%, EUR 37,4%, JPY 9,4%, GBP 11,3%

Source: www.imf.org, 26.02.2015.

It cannot be stated that SDRs play the role of global international currency effectively. The composition of currency basket which is shaping their value, clearly shows that it is the currency primarily shaped by USD (which participation in the basket amounted at almost 42%). Countries that advocate the autonomization of global economy from dollar include: China, Russia, India and Japan. Their idea is to incorporate Ruble, Yuan, gold and silver into the currency basket which is the basis for establishing the SDR value. Additionally, some economists claim the need to include the currencies of countries such as: Brazil, Turkey, India and Indonesia. In this case, the role of Euro, USD, Yen and Pound would be reduced. It seems reasonable to introduce following changes:

- reducing the role of Euro to about 14% (from 37.4%),
- reducing the role of USD to 25% (from 41.9%),
- minor decrease of the Yen role,
- minor decrease of the Pound role,
- adding Ruble with the participation amounted at 10%,
- adding Yuan with the participation amounted at 10%,
- adding gold and silver with combine participation of 20%,
- adding a 10% participation for the currencies of Brazil, India, Turkey, Indonesia.

The introduction of new SDRs could be the basic factor for determining the rates of individual currencies in relation to SDR and thus departing from the floating exchange rates, which undoubtedly would have resulted in the increase of international financial market stability.

5. Conclusion

Further work on the development of stable international monetary system should include the role of developing countries, as their role in the world economy is growing. Re-evaluating the SDRs basing on the new currency basket, including mentioned currencies would undoubtedly be a good solution. This would increase the role of SDRs in the international monetary system and simultaneously would decrease the USD role in this system. The SDRs would play the role of reserve money and would gradually replace the USD. The effect of this would be the decoupling of the world economy from the single currency.

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